

DEPARTMENT OF STATE REVENUE

**LETTER OF FINDINGS NUMBER: 98-0567 ST
SALES & USE TAX
FOR TAX PERIOD: 1994 THROUGH 1996**

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ISSUES

I. Sales & Use Tax – Credit for Tax Paid to Another State

Authority: 45 I.A.C. 2.2-3-16

Taxpayer protests the Department's denial of credit for tax paid to another state.

II. Sales & Use Tax – Wastewater Treatment Equipment

Authority: 45 I.A.C. 2.2-5-70

Taxpayer protests the imposition of sales/use tax on wastewater treatment equipment.

III. Sales & Use Tax – Testing Gauges

Authority: 45 I.A.C. 2.2-5-8; 45 I.A.C. 2.2-5-12; Harlan Sprague Dawley, Inc. v. Dept. of State Revenue, 605 N.E.2d 1228 (Ind. Tax Ct. 1992)

Taxpayer protests the imposition of sales/use tax on testing gauges.

IV. Sales & Use Tax – Packaging Materials

Authority: General Motors Corp. v. Department of State Revenue, 578 N.E.2d 399, (Ind. Tax Ct. 1991); 45 I.A.C. 2.2-5-16

Taxpayer protests the imposition of sales/use tax on packaging materials.

V. Sales & Use Tax – Production Equipment

Authority: IC 6-2.5-5-3; Indiana Department of Revenue v. Cave Stone, 457 NE2d 520 (Ind. 1983); Regulation 45 I.A.C. 2.2-5-8

Taxpayer protests the imposition of sales/use tax on equipment.

VI. Sales & Use Tax – Safety Equipment

Authority: 45 I.A.C. 2.2-5-8

Taxpayer protests the imposition of sales/use tax on safety equipment.

VII. Sales & Use Tax – Improvements to Realty

Authority: 45 I.A.C. 2.2-5-8

Taxpayer protests the imposition of sales/use tax on lump sum improvements to realty.

VIII. Tax Administration – Penalty

Authority: IC 6-8.1-10-2.1

Taxpayer protests the imposition of a ten percent penalty.

STATEMENT OF FACTS

Taxpayer is engaged in the manufacturing of products which are sold to and further processed by auto manufacturers. The metal scrap from the production process is sold by the taxpayer. The auditor assessed a use tax liability for every year of the audit period. Taxpayer protests several items included in those assessments. Additional information will be provided below, as necessary.

I. Sales & Use Tax – Credit for Tax Paid to Another State

DISCUSSION

The auditor assessed use tax on purchases made by taxpayer when tax was paid to another state. Taxpayer claims it is due a credit per 45 I.A.C. 2.2-3-16. The regulation provides, “Liability for Indiana use tax shall be reduced by a credit for the amount of any sale, purchase, or use tax paid to any other state, territory or possession of the United States with respect to the tangible personal property on which Indiana use tax applies.” 45 I.A.C. 2.2-3-16.

The auditor denied the credit as the tax was not properly paid to the other state. Taxpayer claims the tax was paid to another state, and although it was not properly paid, it should result in a credit to the Indiana use tax liability. The Department finds the taxpayer had no sales/use tax liability to the other state. The taxpayer simply volunteered additional payment. Without a tax liability to another state no credit is allowed.

FINDING

Taxpayer’s protest is denied.

II. Sales & Use Tax – Wastewater Treatment Equipment

DISCUSSION

The auditor assessed use tax on equipment, used by the taxpayer, to filter mop water. Taxpayer removes toxins from the mop water prior to releasing the water into the city sewer system. Taxpayer cites 45 I.A.C. 2.2-5-70 which reads in part:

The state gross retail tax does not apply to sales of tangible personal property which constitutes, is incorporated into, or is consumed in the operation of, a device, facility, or structure predominantly used and acquired for the purpose of complying with any state, local or federal environmental quality statutes, regulations or standards; and the person acquiring the property is engaged in the business of manufacturing, processing, refining, mining, or agriculture. 45 I.A.C. 2.2-5-70(a).

The auditor assessed the tax because the filtering system was not mandated by the Environmental Protection Agency. Taxpayer claims that although the EPA does not mandate the filtering system a local ordinance does require it. Pursuant to 45 I.A.C. 2.2-5-70, the gross retail tax does not apply if the purchase was for the purpose of complying with state, local or federal regulations. Taxpayer’s compliance with a local ordinance is included in this exemption.

FINDING

Taxpayer's protest is sustained.

III. Sales & Use Tax – Testing Gauges

DISCUSSION

Taxpayer purchased gauges which were used to test incoming component parts. Taxpayer owns gauges situated at its location and at the locations of its suppliers. The parts are checked twice. The auditor assessed use tax on all gauges except those used by quality control or on the production line. The taxpayer protests and cites 45 I.A.C. 2.2-5-8(i) which states, "Machinery, tools, and equipment used to test and inspect the product as part of the production process are exempt." Taxpayer claims the production process begins with the inspection of the incoming component parts.

Department Regulation 45 I.A.C. 2.2-5-12 defines pre and post-production activities.

Direct consumption in the production process begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production process has altered the item to its completed form, including packaging, if required. 45 I.A.C. 2.2-5-12(d)(1).

The taxpayer argues that introducing materials which do not conform to specifications will produce an unmarketable product. Therefore, the gauges used to inspect the materials are directly necessary in the creation of a scarce economic good. Harlan Sprague Dawley, Inc. v. Dept. of State Revenue, 605 N.E.2d 1228 (Ind. Tax Ct. 1992). Taxpayer argues Harlan Sprague expansively viewed production as all activity which increased scarce economic goods.

However,

The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property 'has an immediate effect upon the article being produced.' Instead ... the property must also be an integral part of an integrated process which produces tangible personal property. 45 I.A.C. 2.2-5-8(g).

Although the gauges are a practical necessity to increase the likelihood of a marketable product the testing itself does not have an immediate effect on the article being produced. The testing does not alter the material and does not, alone, produce a marketable good. The Department finds the inspection and testing gauges are part of pre-production activity and not exempt.

FINDING

Taxpayer's protest is denied.

IV. Sales & Use Tax – Packaging Materials

DISCUSSION

The auditor assessed use tax on packaging material used within shipping enclosures. Taxpayer ships the product in large containers with a thick cardboard material or trim sheets in between layers of product. The taxpayer claims that without the materials in between the layers the products would be scratched, dented or otherwise damaged during shipment. Taxpayer argues the customer bargains for new, undamaged products and the production of these products is not complete without the required packaging.

Taxpayer cites General Motors Corp. v. Department of State Revenue, 578 N.E.2d 399, (Ind. Tax Ct. 1991), which held materials are exempt if they facilitate the shipment of work-in-progress and constitute a part of a continuous process. The Department declines, however, to apply General Motors because this situation does not constitute work-in-progress as part of the continuous manufacturing process.

However, Department Regulation 45 I.A.C. 2.2-5-16 provides, “(a) The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added, and returnable containers containing contents sold in a sale constituting selling at retail and returnable containers sold empty for refilling...”

The Department finds the trim sheets are enclosures and are exempt.

FINDING

Taxpayer's protest is sustained.

V. Sales & Use Tax – Production Equipment

DISCUSSION

The auditor assessed use tax on various pieces of equipment and machinery taxpayer claims are an essential and integral part of the integrated production process and are exempt pursuant to IC 6-2.5-5-3(b):

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

The auditor assessed tax on the purchase of a stretch-wrap machine. The containers which hold the product are secured to the pallet with the plastic wrap. Taxpayer cites Indiana Department of Revenue v. Cave Stone, 457 NE2d 520 (Ind. 1983), for the proposition that the stretch wrap machine is part of the process by which the finished product is derived.

Taxpayer's use of the stretch-wrap machine does not qualify for the manufacturing equipment exemption. The production process ends at the point the processing has altered the item to its completed form, including packaging, if required. Taxpayer has failed to demonstrate the essential and integral nature of the stretch-wrap machine to the packaging of the product, rather than simply the transport of the product.

The taxpayer also protests the assessment of use tax on a scrap conveyor. Taxpayer states the scrap conveyor gathers and transports the scrap material that is a byproduct of the production process. The scrap is sold. Taxpayer claims this is a secondary production process. The Department does not recognize this as an exempt production process. The taxpayer does not argue the conveyor provides any service other than transportation of the scrap metal. The conveyor does not bind the scrap or do anything else which prepares the scrap metal for sale.

Taxpayer protests the use tax assessment against die mules. Department Regulation 45 I.A.C. 2.2-5-8(g) states in part:

Component parts of a unit of machinery or equipment, which unit has an immediate effect on the article being produced, are exempt if such components are an integral part of such manufacturing unit.

Taxpayer states the die mules are a component part of production equipment. The die mules are used to load and unload the stamping dies. Taxpayer claims the die mules are essential and integral to the overall production process and are the only way to change the dies given their size. Taxpayer contends the die mules were purchased with the press itself and are exempt.

However, the die mules do not have an immediate effect on the items being produced. Rather, they merely serve to remove and replace various dies which are used in the production process. The die mules are not component parts of the machinery as they are not an integral part of the machinery. Die mules are not exempt from tax.

Taxpayer also claims an automatic feeder is an integral part of a manufacturing unit. The automatic feeder is attached to a machine which bends metal tubing into the appropriate shape. The feeder is not exempt because it is simply conveying the raw material to the production stage. This is by definition a taxable pre-production activity. Taxpayer's protest is denied.

Finally, taxpayer argues the painting of a production press is exempt from use tax. Taxpayer suggests that once the press is painted the paint becomes a component part. Taxpayer points out that if the press had been purchased with a new coat of paint the Department would not have taxed the value of the paint. Taxpayer claims that when it paints a piece of manufacturing machinery, it is replacing a missing or worn part of the equipment. The paint is a component part of the equipment as it prevents corrosion. Taxpayer's protest is denied. The Department finds paint is not a repair or component part but a maintenance item.

FINDING

Taxpayer's protest is denied with regard to the stretch wrap machine, the scrap conveyor, die mules, automatic feeder, and the press paint.

VI. Sales & Use Tax – Safety Equipment

DISCUSSION

An example given under 45 I.A.C. 2.2-5-8(c) lists types of equipment which constitute essential and integral parts of the integrated production process and are exempt. "The fact that such equipment may not touch the work-in-progress or, by itself, cause a change in the product, is not determinative." 45 I.A.C. 2.2-5-8(c)(2). "Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production" is exempt. 45 I.A.C. 2.2-5-8(c)(2)(F).

The auditor assessed use tax on the purchase of anti-vibration gloves and wrist supports. The items are worn by workers to prevent injury that may result due to exposure of extreme vibration of the manufacturing equipment.

FINDING

Taxpayer's protest is sustained.

VII. Sales & Use Tax – Improvements to Realty

DISCUSSION

Taxpayer protests the assessment of use tax on contracts it says were made for improvements to real property. Taxpayer claims it entered lump sum contracts with various contractors involving the replacement of flooring material in the break rooms and bathrooms. As such, the taxpayer claims the contractor was liable for the sales/use tax. Taxpayer cites 45 I.A.C. 2.2-5-8, in part:

... (e) Disposition subject to the use tax. With respect to construction material a contractor acquired tax-free, the contractor is liable for the use tax and must remit such tax (measured on the purchase price) to the Department of Revenue when he disposes of such property in the following manner:

... (3) Lump sum contract. He converts the construction material into realty on land he does not own pursuant to a contract that includes all elements of cost in the total contract price...

The installation of the flooring material was an improvement to realty. Taxpayer argues this was a lump sum contract and the contractor was liable for the tax.

FINDING

Taxpayer's protest is sustained pursuant to audit verification of the lump sum contracts.

VIII. Tax Administration – Penalty

DISCUSSION

The Department assessed a ten percent penalty. The taxpayer protests the penalty and argues the assessed items "either qualify for exemption or are questionable in nature with respect to taxability." Protest Brief, section VIII. Taxpayer argues pursuant to Indiana Code section 6-8.1-10-2.1, the penalty should be waived because the taxpayer had "reasonable cause" for the failure to pay sales tax due.

FINDING

Taxpayer's protest is denied. With respect to those protested items listed above which were denied, taxpayer had no reasonable cause for failure to pay the taxes. Taxpayer had two prior audits and did not make adjustments accordingly. This audit resulted in higher assessments.